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4 Book entries and their relationship to accrual accounting and accounting assumptions

4.1 Introduction

Cash accounting has the disadvantage that deferred and expected revenues as well as deferred and expected expenses are not taken into account in a company's financial information, thereby affecting the relevance of the information because information which may affect future financial statements is recorded in the current financial statements. When information is not relevant for the current decisions, the integrity of the information may be influenced. Accrual accounting overcame this problem through the use of the matching assumption. The matching assumption is used to match revenues and expenses in the same period, the balance, being either an expense or a revenue, is then reflected in the balance sheet as a deferred or expected expense or revenue. Companies may also have to make provision for an uncertain future happening called a contingency, in the financial statements. An asbestos mining company may face a lawsuit because of miners who fell ill and the company may somehow have to budget for these. These uncertain future happenings may have an influence on the integrity of information. The classification of items in the balance sheet may have different effects on the information portrayed in the financial statements of a company, for example when deferred taxation is classified as debt versus being classified as part of equity. A company may also need to make provisions for normal future costs, for instance the depreciation provision and deferred taxation provision in order to adhere to the matching assumption. In times of uncertainty a company may decide to make use of the assumption of conservatism by understating its assets, once again influencing the integrity of the information of the company.

This chapter considers the role of transactions in accrual accounting, definitions and

discussions of each of the accounting assumptions of matching, contingencies, classification, provisions and conservatism. Ratios are also discussed since these are used to portray the financial health of a company. Towards the end of a brief discussion is presented on accumulated depreciation and deferred taxation as examples of book entries which may affect the integrity of information. A summary concludes this chapter.

4.2 The role of transactions in accrual accounting

Accrual accounting probably originated from the Industrial Revolution which revealed inadequacies in purely cash recording, given the complexities of trade, commerce and industry. Cash recording failed to accurately measure the "net financial result" of periodical business activities. Accrual accounting provided a remedy by bringing into account deferred or expected elements of revenue or cash outlays. These elements could be viewed as appropriate to the period under review even though the cash impact would only be seen at a later period. When a period of volatility is experienced in the financial unit of measurement (e.g. R, $, £, ¥, etc.) it follows that the assets of a company must be revalued. There is currently no system proposed by any of government, tax legislatures or academics that can be used as a guideline in this revaluation process (Goldberg 2001). However, when a company decides to revalue its assets, the bottom line of that company may be affected considerably. Book entries are used to revalue assets and increase or decrease the depreciation provision, which in turn decreases or increases the profit or loss, the dividend payout and the distributable reserve.

The difference between cash accounting and accrual accounting is one of timing and matching (Wild *et al.* 2001). Accrual accounting has a number of benefits as well as some drawbacks. One of the benefits is that accrual accounting reduces timing and matching problems. The credit economy necessitates accrual accounting where a transaction is recorded when the goods are delivered, although there is no immediate

transfer of cash involved. An important benefit of accrual accounting over cash accounting coincides with a main goal of accrual accounting as described by Wild *et al.* (2001:115) "... to make adjustments for transactions that have future cash flow implications, even when no cash inflows or cash outflows occur contemporaneously – an example is a credit sale". A well-known problem with a credit sale is that the debtor might never pay in which case the transaction has to be 'reversed' when a provision for the doubtful debt is made. (It may even be said that no transaction occurred.) According to Glautier and Underdown (1997) the accountant must make sure at a financial year-end that all the income the company is legally entitled to, is recorded. This happens even if no cash was received and no economic event took place. Referring back to the credit sale, book entries are used to make provision for doubtful debts, which in turn may influence the integrity of the information portrayed in the financial statements.

A number of problems arise when cash accounting (ordinary accounting) is used. Table 4.1 below lists some of the problems encountered in (ordinary) accounting but solved by accrual accounting.

Table 4.1: Problems solved by accrual accounting

Transaction	**Accrual accounting**	**Problem solved**
Cash purchase of inventory	Increase in inventory	Matching
Credit sale	Revenue when goods are delivered	Timing
Cash purchase of machine	Increase in assets Depreciation of assets	Matching

(Adapted from Wild *et al.* (2001).

Table 4.1 effectively shows the mechanisms used by accrual accounting in solving

either the matching or timing problems.

When dealing with accrual accounting, it is important to note that accrual accounting is based on a number of assumptions (Wild *et al.* 2001):

- Going-concern: the entity will continue its business activities into the foreseeable future. This assumption allows accrual accounting to recognise business activity before cash inflow or outflow.
- Enforceability of contracts: most accrual entries are based on source documents, usually a contract.
- Stable monetary unit: assumes stable prices.
- Time value of money: assumes present value concepts.

Assumptions, estimates and judgements are used in accrual accounting to introduce softness or uncertainty into accounting numbers. Whenever uncertainty, estimates or judgements are involved, it follows that the integrity of information is influenced by these and may be different to information based on reality. However, despite numerous criticisms, accrual accounting is useful for financial analysis but an accountant has to be aware of its shortcomings.

4.3 The relationship of book entries with certain accounting assumptions and the use of ratios

4.3.1 The matching assumption

The matching principle was introduced in 1940 (Most 1982). Matching is one of the accounting principles that directly influences book entries and is based on an assumption made by accountants that there is a cause and effect relationship between expenses and revenue over time (Kam 1990). Items in accounting that are based on the

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matching principle include deferred taxation, research and development costs, contingencies, and provision for depreciation and pensions. These are all created by book entries and may influence the integrity of information.

Matching may be described as a way to tie expense recognition to revenue recognition at a time when it is practicable to do so (Mulford and Comiskey 2002). The matching of revenues with expenses may be difficult, since some costs have a benefit for the future. As Kam (1990:283) puts it: "Proper matching is difficult. It implies not only that the actual using up of assets and services is for the period identified, but also that the value of the used assets and services is computed correctly". When time is taken into account, matching becomes difficult because it is often hard to determine the time span of an entry. Furthermore, the allocation of a value to a particular period is also a non-trivial task. Matching is based on a person's (subjective) perception and may therefore, influence the integrity of information supplied in the financial statements.

Kam (1990) lists three basic issues an accountant considers when matching revenues with expenses:

- association of cause and effect;
- systematic and rational allocation; and
- immediate recognition.

Ideally, for every expense (cause) that takes place, a revenue (effect) must be created. However, not all expenses can be matched this way. In some cases time plays a crucial role and this calls for the allocation of costs, either immediately or over a period. Immediate recognition takes place if an expense is not covered by either of the first two bulleted items above. This method of allocating costs is well known in the accounting world, but once again allocation is also based upon the perception of management, and

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may therefore give rise to information of a different integrity than the information created by real transactions.

The application of the matching principle often has the unfortunate effect of using the balance sheet as a sink for unexpired costs (i.e. costs incurred in the past that may be matched with future revenues) as they await their time of expiry on some future income statement. However, a balance sheet ought to play a more important role than just being a repository for these costs. Although accountants agree that the balance sheet is a source of information about the financial position of the company, the procedures they follow often violate the intended use of a balance sheet (Kam 1990). Deciding which costs should be spread over a period and which not, has a very important effect on the information supplied in the balance sheet because it is based on the personal judgements of management. Since the balance sheet is a mix of what happened and what is going to happen, these personal judgements also influence the integrity of the information supplied.

Matching and timing together are vehicles for distinguishing between accrual accounting and cash accounting. In this way accrual accounting overcomes both the timing and matching problems (refer table 4.1) that are inherent to cash accounting (Wild *et al.* 2001). Expenses related to the revenue created are matched with cash received over the same period and an amount for outstanding debtors is created. The expenses incurred for the sales to outstanding debtors are then only debited to the income statement when the debtors eventually pay. The allocation of costs is done via a book entry.

There are specific guidelines when matching occurs with regard to direct-response advertising, research and development costs, software development and interest during extended construction periods. Despite these specific guidelines, a great deal of

flexibility exists during matching (Mulford and Comiskey 2002). The observer's interpretation of these guidelines results in this flexibility, and personal interpretation may influence the integrity of information – either positively or negatively.

Matching furthermore solves the problem of the distortion of the bottom line of a company when all expenses and revenues (economic events) are recorded in the relevant period, according to Sprague (1920). When all the relevant economic events are not recorded in a period, the information may prove to be valueless and the period which has been influenced may appear prosperous at the expense of one which is actually more successful. Suppose a company buys cellulose from a supplier in January and only pays for the cellulose in February the same year. The company subsequently uses the cellulose over a period of three months, starting in January. Now, if the whole expense is taken into account when paid, February would seem to be a 'bad' month. If, however, the expense is spread over the period of use, each month would appear to be a better month and the quality of the information supplied may be of a better integrity.

Matching does, however, have a down side. The matching concept was heavily criticised by Robert T. Sprouse (1973:167-168): matching creates "unique accounting products" like deferred charges that are not assets and deferred credits that are not liabilities. "The matching concept necessarily relies on ad hoc decisions rather than on accounting theory – on independent value judgements rather than on consistent analysis". When looking at the matching concept in this way, it becomes clear that matching takes place rather subjectively. Book entries are usually based on the matching concept, hence these may also be viewed as subjective in nature. Thomas (1975) calls matching the accountants' only allocation theory and views matching as the only way accountants can defend GAAP allocation rules. All this means that the profit or loss calculated in the income statement is little more than a book entry, because so many book entries are allocated to the income statement based on the matching

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assumption.

The diversity in activity in business does not lend itself towards accurate matching in the valuation of an asset. The valuations carried forward in the balance sheet have no particular relationship to specific current benefits; therefore, the remaining values have no particular relationship to future benefits. The usefulness of the matching concept in providing relevant information to investors and other stakeholders, is questionable when valuation is based on the use of the deferred charge classification and the allocation of the cost of intangibles (Burns and Hendrickson 1986). When depreciation is provided on the basis of a calculation of the revaluation of assets, the profit or loss before tax as well as after tax is influenced, together with retained earnings and dividends. This argument illustrates how many items in the financial statements may be influenced by book entries.

4.3.2 Contingencies

Contingencies are divided into assets and liabilities and are possible gains and losses whose declaration depends on one or more future events (Wild *et al.* 2001). A contingent liability results from a loss, for instance, when a company worked with hazardous materials which affected the health of their employees and the employees filed a law suit after one of their colleagues died. The company thereafter faces a big loss of income based on the evidence and therefore needs some provision in their financial statements brought about by a book entry. When a book entry is based on some future event and uncertainty, it follows that the integrity of the information created by a book entry may not be the same as that created by a real transaction. Contingent assets are only disclosed in the notes to the financial statements when their occurrence is very likely. Rights or claims in court cases, donations and bonuses are classified under contingent assets (Wild *et al.* 2001). A right or a claim is based on a future happening and therefore contingent assets may be brought about by book entries. The

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value of the contingency may also be based on the subjective opinion of management and therefore the integrity of such information may be influenced.

Other forms of contingent liabilities may arise from a threat of expropriation, collectibility of receivables, claims arising from product warranties or defects, guarantees of performance, tax assessments, self-insured risks, and catastrophic losses of property (Wild *et al.* 2001). Again the contingent liabilities are based on future happenings and are brought about by book entries. To add a value to these contingent liabilities may be a very challenging task which is left to the judgement of management, which in turn may influence the integrity of the information supplied in the financial statements.

To be classified as a contingent liability, firstly, it must be probable that an asset will be impaired or a liability will be incurred and secondly, it must be reasonably estimable. When it is not possible to reasonably estimate the obligation, footnote disclosure is appropriate. Contingent liabilities are dependent on the occurrence or non-occurrence of one or more future events (Mulford and Comiskey 2002). This means that contingent liabilities are definitely created by book entries that are based on future happenings. If it is not possible to estimate the obligation, it may influence the integrity of information accordingly.

Loss contingencies are based upon the forfeiting of some future economic benefits. Fortune (1986:461) defines a loss contingency as “a probable future sacrifice of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events where the settlement depends on one or more future events that have some probability of occurrence”. Given the above definition it is clear why analysts often do not find the information content of financial statements very useful – events are based on the past, yet refer to the future and are therefore very uncertain. The information

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created by this book entry will certainly affect the integrity of information.

4.3.3 Classification

Classification in accounting is of the utmost importance in the financial statements. Classification is based on the identification of one or more characteristics which a number of occurrences or events have in common, and the subsequent arrangement of these occurrences or events is according to these characteristics. Classification is a subjective activity according to Goldberg (2001) and something that may be done automatically. Goldberg goes further and suggests that classification places constraints on the interpretation of the characteristics being recorded about an occurrence. Whenever there are constraints on interpretation, it follows that the integrity of the underlying information may be impaired.

Time is one of the building blocks where book entries are concerned. Book entries are also used to classify items for year-end statements and may be viewed as reversible (i.e. reversible book entries). Classification exists only for a moment. Many records in the ledger of a company are provisions and are therefore subject to adjustments later. At month end or year-end, work must continue without interruption and this leads to some degree of roughness which can be corrected in the next balance sheet and which, until that time, does no harm. Sprague (1920) argues that in order to make the balance sheet close to perfect, adjustments must be made. “The question now arises, should these adjustments be affected by supplementary entries in the current accounts or should they be ignored in the regular books and only appear [through] their influence on the balance sheet? I should decidedly prefer the former course as making the results of valuation and derivation coincide; at least for a balance sheet which is intended for the information of the proprietors. Where a balance sheet or report is required by some outside authority, it may be that the point of view required is so alien to that assumed in the accounts themselves that no adjustment is practicable; they are constructed on

a different basis" (Sprague 1920). In the experience of the author the practice described by Sprague still prevails today. Financial statements may not be very user-friendly for decision-making purposes since these are drawn up mainly for the inside stakeholders and not the outside stakeholders (Refer to section 2.3.5 Plank and Blensly).

4.3.4 Provisions

According to the Companies Act no. 61 of 1973, Schedule 4 (South Africa 1973), provision means: "any amount written off or retained by way of providing for depreciation or diminution in value of assets or retained by way of providing for any known liability, the amount of which cannot be determined with substantial accuracy". If an amount cannot be determined with substantial accuracy, it may follow that the integrity of information created by a provision may not be the same as the integrity of information created by a real transaction.

In assigning semantics to the word 'provision', one can say that it is the action of earmarking something. To 'earmark' means "to keep in mind for a special purpose" or to set aside for a special purpose (Hornby 1981:273). A definition of provisions as supplied by Kirk (1999) as well as the AC130 accounting statement (Hemus *et al.* 2000) implies that a 'provision' is a liability of uncertain amount or timing. A provision represents a probable future cash outflow from the reporting company although the company does not know when or how much will be paid. A provision (book entry) based on uncertainty may not reflect the same integrity as information based on real transactions.

An aspect related to provision, namely a *future happening*, is described by Goldberg (2001:56): "The information available about any given set of circumstances is always about something which has happened, whether recently or long ago. (Part omitted). Any prognostication of future happenings is a matter of speculation, based, perhaps, on

deduction from logically recognized premises but none the less speculation about what might happen; its limitations are those of the absence of omniscience, not only about the status quo in total or in general, but also about the nature of the relationships between the numerous elements which constitute it and make it recognizable". If a provision is seen as speculation about what might happen, it is clear that the integrity of information created by book entries might not be the same as the integrity of information created by transactions that are based on facts.

4.3.5 Conservatism

Conservatism is an approach whereby a company makes an understatement of its net assets, rather than an overstatement, that is, the company paints a gloomier picture than is probably the case. This approach is normally followed when a company is confronted with some kind of uncertainty. Wild *et al.* (2001:98) view conservatism as outlined next: "Conservatism reduces both the reliability and relevance of accounting information in at least two ways. Firstly, conservatism understates both net assets and net income. (Part omitted). A second point is that conservatism results in selectively delayed recognition of good news in financial statements, while immediately recognizing bad news". When good news is delayed because of conservatism, it follows that information created in this manner would not have the same integrity as it would have had, had the good news been portrayed immediately.

When the principle of conservatism is applied, the accountant should be watchful that it is not just a way to smooth income, that is, to simply buffer the company against negative sentiment from the market. Hence, the changing of a company's depreciation policy or revaluation of their assets may be seen as a conservative move or as a way to smooth their income (Getschow, 1986). It is important to note in this regard that conservatism is realised by a book entry.

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The fear factor often goes hand in hand with uncertainty. “Conservatism does not focus on evidence, but on the fear of overstatement of net assets and profits. It is an attitude that has become a convention in accounting. Misleading information can be the result” (Kam 1990:289). If conservatism is based on fear and not on reality, conservatism can lead to misleading information and thereby impair the integrity of information.

4.3.6 The use of ratios

Ratios are used as a popular tool to analyse financial statements. It is well known that a ratio is an expression of a mathematical relation between two quantities (Wild *et al.* 2001), and it is important that some sensible relationship exists between the two quantities under consideration. Computing a ratio is a simple arithmetic operation, but the interpretation of the answer is more complex. When the results are interpreted, the process requires “a mastery of a technical application of the analysis of the data and a number of relationships (or ‘ratios’) between commonly found components in many accounting reports (Part omitted). But the validity of applying such ratios should be addressed by relating them to the actual use of the report by the recipient(s)” (Goldberg 2001:54). For example, a company lending money uses certain ratios; investors in turn need a different set of ratios while the management of companies may need a third set of ratios. Ratios are made up of real information as well as artificial information. Real information is represented by real transactions and artificial information is based on book entries that may be concerned with the subjective opinion of management of some future happening. The combination of real and artificial transactions may have a big impact on the integrity of the information created by the outcome of a ratio. As with all information on which important decisions are based, users of ratios need to know that the value of any such ratio is beyond suspicion.

Table 4.2 below shows which ratios may be used as indicators of failure in companies. The information in the first three rows was researched and synthesised by the

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researchers as indicated (Wild *et al.* 2001). Beaver in Foster (1986), conducted a similar survey of companies that failed and identified the set of ratios set out in the fourth row in Table 4.2.

Table 4.2: Ratios predicting failure (Author created)

Researcher	Ratio as best predictor
Winakor & Smith	1. Net working capital to total assets
Fitzpatrick	1. Return on net worth 2. Net worth to total debt
Merwin	1. Current ratio 2. Net working capital to total assets 3. Net worth to total debt
Beaver	1. Cashflow to total debt 2. Net income to total assets 3. Total debt to total assets 4. Net working capital to total assets 5. Current ratio

Beaver ranked the ratios used in his research from the most to the least indicative predictors of possible failure of a company:

- First: cash flow to total debt
- Second: capital structured ratios
- Third: turnover ratios.

Beaver found that the above ranking results for companies measured over a short period of time were the same as corresponding measurements taken over a much longer period of time (Wild *et al.* 2001). When analysing a company's financial reports,

it is very useful to know which ratios are indicators of failure and how to rank them. This will guide the decision maker in his or her approach to making the necessary decision. Some of the above listed ratios will be used in the analytical research of this dissertation to show the effect of book entries on information for decision-making purposes. Book entries, amongst other entities, are used in the calculation of these ratios. In using ratios that contain book entries or artificial information, one should take into account the possible effects of these entries. If a ratio is influenced by information of a lesser integrity, the result may lead to wrong decisions (Gouws 2003a).

Ratios may be classified according to either the company's trading (operating) record or their financial structure. The classification of these ratios and their subcategories, is stated by Ellis and Williams (1993) and is presented in more detail in Table 4.3 below:

Table 4.3: Ratio categories

Operating or activity ratios		**Financial ratios**	
A company's trading history		A company's financial structure	
Overall performance	Working capital ratios	Debt ratios	Liquidity ratios
Overall performance is measured	Control	Extent to which a company is financed by loan capital and its ability to service debt	Company's ability to meet any short-term cash requirements

(Ellis and Williams – adapted)

Table 4.3 effectively shows how ratios are classified into two categories and two subcategories each.

4.4 Depreciation and deferred taxation as examples of book entries

Depreciation and deferred taxation are offsprings of accrual accounting. Both depreciation and deferred taxation have matching and timing consequences (Wild *et al.* 2001). They are book entries that have observable effects on the financial statements of a company. Since these particular book entries are used for the financial analysis in this dissertation, a more detailed discussion is required.

4.4.1 Depreciation

Depreciation may be defined as a measure of consumption of a fixed asset. Depreciation is charged against the income statement but does not involve a movement in cash. "It is simply an artificial means of accounting for the degree to which a fixed asset is consumed in the accounting period. Hence, the notional funds set aside for depreciation are available to meet cash outgoings" (Ellis and Williams 1993:17). Depreciation has the effect of decreasing reported profits, while leaving cash flow unaffected. The allocation of a depreciation cost to the income statement has its origin in accrual accounting. The notional funds mentioned by Ellis and Williams (1993) are seen as internal funds for the replacement of a fixed asset. These internal funds are not available for other cash outgoings. Depreciation is often seen as a means of decreasing profit upon which the company will be liable for less income tax. It follows that the integrity of information is affected when a company makes use of a book entry to decrease their tax liability.

Depreciation is furthermore viewed as a recovery mechanism employed by the company of the investment in fixed assets out of selling prices even before a profit is realised (Wild *et al.* 2001). As mentioned above, depreciation recovers cash which should be utilised for the replacement of fixed assets. Profit or loss on the sale of a fixed asset is not a real profit or loss but rather an under- or over provision of depreciation. According to Lee (1984), the economic reality underlying the profit or loss on the sale

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of an asset that came about when provision for depreciation was made, is in doubt, because there is a fall in either the selling price of the asset or in the cash flow generated from this sale. The profit or loss on the sale of a fixed asset is based on a calculation influenced by book entries and may affect the integrity of the information supplied on this event.

The definition of depreciation as previously stated by Ellis and Williams (1993) coincides with the definition Most provided. Most (1982:371) defines depreciation as "a measure of the planned (or expected) sacrifice of value of a fixed (capacity) asset necessarily resulting from [a] planned (or [an] expected) sequence of production operations. Depreciation expense, then, is the analysis of depreciation by periods of time, and depreciation cost, the analysis of depreciation by process or product". According to Most (1982), any explanation of depreciation based on something that happened is false. It follows that depreciation cost may not be a retrospective calculation of the effect of something that has happened. To evaluate financial structure and analyse profitability, accumulated depreciation is not deducted from cost in order to calculate written-down value directly. The purpose may be to disclose data for calculating the following ratios: accumulated depreciation/gross cost of fixed assets and net income/total investment at cost.

If a company makes provision for the depreciation of fixed assets, it necessarily reduces the amount of profit available for distribution and thereby retains cash in the business; hence in theory the cash that is left in the business can be used for other purposes, for example, providing cash for future investment in fixed assets (Williamson 2003). The problem that managers of companies are faced within this regard is that this internal fund is hidden in the working capital. Hence, the spirit of this dissertation is to provide justification for the argument that an internal fund should be classified separately from the working capital and that such funds should be used for the replacement of fixed

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assets. According to Wilson (1974:248) "... the sum of depreciation and retained earnings (i.e. the *cash flow*) is an important source of finance. (Part omitted). If depreciation allowances exceed the current level of capital expenditure, they may add to working capital, and eliminate the need for short-term borrowing. On the other hand, if depreciation allowances are exceeded by capital outlays, it may have the effect of depleting working capital, or requiring the company to borrow" (Refer to section 2.3.4). The creation of internal funds through the depreciation provision, therefore, appears to be one of the best ways to fund the replacement of fixed assets. The internal fund must, however, grow with inflation so as to prevent the problem of the fund being unable to meet future replacement of assets. In other words, if stakeholders are under the incorrect impression that such funds are sufficient for any future replacement of fixed assets, then decisions based on such compromised information may have severe effects on the future of the company.

4.4.2 Deferred taxation

Deferred taxation is based on timing differences. This viewpoint is shared by Mulford and Comiskey (2002) and Wild e*t al.* (2001). Mulford and Comiskey (2002) report that the deferred income tax expense has its origin mainly because of temporary differences between the book income (pretax earnings reported on the income statement) and taxable income, on which the current income tax is calculated and reported on the tax return, all for the same period. Book entries are mainly concerned with temporary or timing differences, hence deferred taxation is positively classified as a book entry. According to Wild *et al.* (2001), deferred tax liabilities will only become payable when a company starts to report losses. Since this future reversal is only a remote possibility, for instance, with timing differences due to accelerated depreciation, the deferred credit that exists may be viewed as a source of funds and therefore be classified as equity. Conversely, if the possibility exists that the reversal will take place in the foreseeable future, then the deferred tax may be classified as a long-term liability. Whether deferred

taxation is viewed as an asset or as a liability, a book entry is used to portray this provision in the financial statements of a company. Because deferred taxation is based on some future conditions and realities, deferred taxation may influence the integrity of the information.

Deferred taxation represents the cumulative difference between taxes calculated at the statutory rate and taxes actually paid. The difference reflects the tax outcomes, for future years, of the differences between the tax bases of assets and liabilities and their carrying values for financial reporting purposes. A further viewpoint from Wild *et al.* (2001) is that deferred income taxes (e.g. a deferred liability) are large and important entities. Deferred income taxes are not liabilities in the usual sense because the national receiver of revenue has no definite claim against a company, neither in the short-term nor in the long-term. Fridson and Alvarez (2002:300) asked the following question: “Are deferred taxes part of capital? Near the equity account on many companies' balance sheets appears an account labelled *Deferred Income Taxes*”. Many analysts argue that a company's net worth is understated by the value of the deferred tax liability, since it will in all likelihood never become payable and is therefore not a liability at all. According to Fridson and Alvarez (2002), proponents of this view adjust the company’s net worth by adding deferred taxes to the denominator in the total-debt-to-total-equity ratio, for the alleged understatement. The above statement highlights another instance where the integrity of information created by book entries is not the same as the integrity of information created by real transactions.

4.5 Summary and conclusion

In this chapter it was observed that the practice of accrual accounting overcomes both the timing and matching problems inherent to cash accounting. An important aspect that emerged in Chapter 2 was reinforced above, namely that there is a difference between the integrity of information created by *real transactions* and the integrity of information

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created by *book entries*. Reliance on the integrity of information supplied in the financial statements of a company is an important concern for any stakeholder. Ratios that are influenced by book entries do not supply information with the same integrity as ratios that are not influenced by book entries. This claim will be substantiated in Chapter 7 which contains the results of the analytical research.

In Chapter 5, the smoothing of income, big baths and earnings management are discussed and it is shown how conservatism and matching may lead to these practices. All these effects are brought about by book entry accounting. Book entries may therefore be very powerful tools in the hands of an accountant.